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Editorial

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EDITORIAL

Instructions for Verification of Financial Statements

Accountants in all parts of the country have awaited with a good deal of impatience the publication of the text which occupies the leading place in this issue of THE JOURNAL OF ACCOUNTANCY. Bankers and credit men also have expressed a keen interest in the authoritative opinions which it was known the text would convey. Probably there has never been an utterance upon accounting more widely expected than this. And yet very little has been said officially on the subject and the committee of the American Institute of Accountants which has been engaged in the task of authorship has maintained a silence which must have been somewhat distressing to anyone who believes in the policy of the open mouth. It was a heavy duty which the committee assumed, and the amount of time actually devoted to the work was extraordinary. During an uncounted number of all-day sessions in the quiet of one of the old New York clubs the members of the committee reviewed, rewrote, added, struck out, simplified—all the while endeavoring to keep in mind the excellent usefulness of the original document upon which the recension was based—until at last all changes had been unanimously approved, the comments and instructions had been coördinated and the report was ready for presentation. The title, *Verification of Financial Statements*, is new and certainly better than the old, *Approved Methods for the Preparation of Balance-sheet Statements*, to which there had been a good deal of opposition. Some critics felt that the old title was misleading or not sufficiently comprehensive. Much of the content is new. It is believed that every important addition to the original matter, required by changed conditions of business or by inadequacy in the first text revealed during an experience of twelve years, has been made. Some of the alterations suggested by accountants, bankers and others have been accepted and embodied in the report. Others were carefully considered and rejected because they did not seem applicable except in specific and perhaps infrequent cases. The new text will meet the constantly growing need for an official utterance on the modern practice of accountancy, and if it be found that some minor detail has been omitted or some rule which has been laid down seems to an accountant here or there too exacting, that is only to be expected. A general treatise which met with unqualified approval of the good, the bad and the indifferent would be a sorry thing indeed. The truth is that the report is the most representative pronouncement upon the vital question of accounting procedure which has been made in this country.

The Background

The history of the case is fairly well known. While this country was vacillating between neutrality and participation in the world war, a new arm of the government was created and named the "federal trade commission." The commission had an enormous undertaking before it. The country's business was not invariably well managed. Hundreds of thousands of corporations, partnerships or persons engaged in trade were ignorant of the cost of production, handling, selling, etc., and it was estimated that more than half the total number of businesses in the country had not even a vague notion of what was involved in modern accounting or what could be accomplished by it. There were few taxes in those days and there was practically no supervision of trade methods. Every company, or perhaps every company department, was a law unto itself. American business had jumped into the forefront of international affairs as the older nations battled for existence. Vast prosperity was at our door and would come in whether we welcomed it intelligently or not. And the American business man did not seem to know quite what to do about it. We were much like the man with a huge sum of money in the bank and no knowledge of cheque writing. Someone was needed to inculcate the fundamental principles of trade, commerce and industry. The federal trade commission had the vision to discern the conditions and the needs. It accomplished many splendid things, and, if some of its efforts excited adverse criticism or positive opposition, no one can reasonably deny that business as a whole owes a debt of gratitude to the commission, especially for its wisdom and assistance in the early years.

Why the Original Text Was Written

The first chairman of the federal trade commission, Edward N. Hurley, was a firm believer in the theory that the accounts of a business should be so kept and so audited that creditors and shareholders may have the comfortable assurance of the probability of accuracy and safety. He knew well that there was not uniformity in the methods and thoroughness of accountants, and he was sufficiently ahead of his time to think that there should be an irreducible minimum of investigation and verification before certification of any financial statement. Some prominent men of business at that time were led to extremes by their desire for reform, and there was suggestion of a uniform system of accounting and auditing for all sorts and conditions of business. This excess of zeal retarded progress. The fallacy of the theory of a universally adaptable programme of accounting procedure was recognized at once. It was, and always will be, impossible to devise a plan which would meet the necessities of every kind of enterprise. But there are many factors common to all commercial and industrial ventures, and it is not impossible to lay down an outline of the procedure which should be followed in almost every conceivable variety of business entity. Mr. Hurley shared the belief of the American Institute of Accountants that something could be done to encourage the adoption of proper precautions by preparing and distributing a set of instructions which would serve as a guide to accountants, bankers, credit men and the business public—not that such a prescription could be complete or restrictive but that it would at least show clearly the level below which the accountant could not go and certify the alleged verity of the accounts. Many accountants had already prepared manuals of procedure for the direction of their staffs and there were bankers who had given frank endorsement to the theory that the auditor should be not only permitted but required to perform certain duties before he should be asked to affirm his faith in the veracity of the statements of accounts, especially those to be used as a basis of credit. With some of these manuals as a point of departure, the movement for reform began.

How the Text Was Published

Mr. Hurley approached the American Institute and requested assistance in the campaign which was about to be inaugurated. Conferences in the Institute offices and at Washington followed. The Institute's committee on federal legislation was instructed to coöperate with the federal trade commission. The committee consisted of the president (W. Sanders Davies), Harvey S. Chase, George O. May and Robert H. Montgomery. Other members of the Institute were consulted during the preparation of the committee's report, and the council of the Institute unanimously approved the programme of audit which was recommended. The title first given by the trade commission to the product of the committee's labors was *Uniform Accounting*, an unfortunate and misleading name which was enough to have wrecked the whole undertaking. But there was such urgent demand for a code of procedure that the unhappy designation was not fatal. Mr. Hurley took the report of the committee over to another branch of the administrative machinery, the federal reserve board, and advocated general distribution of the text to bankers, credit grantors, and the business public generally. This proposal was followed by conferences between the reserve board and the Institute's committee. A few changes were inserted by advisors of the reserve board, and the matter was then printed in the *Federal Reserve Bulletin* for April, 1917. The board did not extend formal approval to the plan of procedure but published it as a tentative proposal and commended it to the consideration of persons concerned with the credit structure of the country's business. The board apparently felt that there might be some doubt of its right to set itself up as an authority on the technique of accounting and therefore withheld official sanction, but the value which members of the board placed upon the plan was made plain in the following paragraphs from the introduction:

> "It is recognized that banks and bankers have a very real interest in the subject, because they are constantly passing upon credits based upon statements made by manufacturers or merchants.
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> "It is quite as much of vital interest to merchants and manufacturers, because they realize that their credit sometimes suffers by reason of losses incurred by bankers through credits given to merchants and manufacturers whose statements do not correctly reflect true conditions.
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> "Lastly, it is of immense importance to auditors and accountants, because they have a professional as well as a practical interest in having the character of their professional work thoroughly formulated and standardized. Losses incurred by bankers by reason of credits given to

merchants or manufacturers, if such credits were given because the statements were either actually false or misleading in their nature, tend to discredit accountancy as a profession and to shake the confidence of bankers in the real value of any statements.

"Hence it is that the federal reserve board puts out this tentative proposal with the hope of encouraging the fullest criticism and discussion.'

The *Bulletin* in which the instructions were printed did not suffice to meet the demands for copies and the matter was reprinted in pamphlet form by the board and offered for sale. After the first edition of the pamphlet, the board was induced to change the title to *Approved Methods for the Preparation of Balance-sheet Statements* and under that much better name the pamphlet appeared in successive editions until the total sales amounted to sixty-five thousand copies. At that point the board ceased to reprint, and before long the instructions were out of print and unobtainable.

Another Chapter of the History

And now, as the Victorian novelists used to say, it is necessary to retrace our steps and take up the narrative at another point. In 1925 and 1926, the Institute's committee on education undertook a survey of the whole field of accountancy and gave special consideration to classification of services which accountants are required to render in the pursuit of their professional calling. After deliberations which lasted several months the committee presented a report proposing a scheme of classification which involved some rather controversial questions. The committee itself was not unanimous. One of the five members dissented from the opinion of his colleagues with reference to some of the recommendations. The report went from the council to the general meeting of the Institute in September, 1926, and provoked prolonged argument. Everyone, apparently, admitted the helpful nature of the report but there were honest differences of opinion on many of the details. It seemed inexpedient to hasten a decision on the points at issue, and accordingly it was resolved that the matter should be referred to the executive committee with instructions that the report should be printed as a confidential document and sent to the members with a request that they give consideration to the proposed classifications and express their conclusions to the executive committee. That committee was given power to make whatever changes seemed to be desired by the majority of the membership and thereafter to publish the report as an official document. A questionnaire was prepared in accordance with this mandate and sent to all members and associates. Emphasis was laid upon the desirability of a comprehensive reply from the entire membership. The committee did everything possible to stimulate interest and to encourage response. When it became evident that the first questionnaire would not produce replies enough to be regarded as the voice of the Institute, the matter was brought again to the attention of members and two more efforts to induce every member to reply were made. The executive committee then found itself in a rather awkward predicament because the replies which were received differed so materially that it was practically impossible to harmonize them in the narrow range of a committee report.

A New Committee Appointed

The committee, therefore, was confronted by the necessity of doing what always must be done in such circumstances. A special committee was appointed to take up the whole question of classification, to study the opinions expressed in the replies to the questionnaires, to consult with other members and finally to bring to the executive committee the results of its deliberation. The special committee, as has been said, spent a great deal of time in survey and in the preparation of its report, but only one or two changes in personnel occurred during the whole course of the work. Several of the most eminent and also the busiest accountants in the country gave time and talents without stint to the accomplishment of the task set before them. We may let the names of the committee members speak for themselves of the prestige and authority with which the report is vested. It has been a traditional editorial policy of THE JOURNAL OF ACCOUNTANCY to refrain from the mention of accounting firms by name, but in this one instance it seems judicious to give brief descriptive notes about the men who have rendered this signal service to the profession. The report bears the signatures of Arthur W. Teele (chairman), member of council of the Institute, partner, Patterson, Teele & Dennis; William B. Campbell, chairman of the Institute's special committee on coöperation with bankers, partner, Price, Waterhouse & Co.; W. Sanders Davies, first president of the American Institute, member of council, partner, Davies & Davies; F. H. Hurdman, president of the American Institute, partner, Hurdman & Cranstoun; William H. West, past president of the American Institute, member of council, partner, West, Flint & Co., and John R. Wildman, chairman of the Institute's committee on education, partner, Haskins & Sells.

The Report Is Written

This committee decided at the outset that one of the subjects which must be considered as germane to the main question of classification was the kind of services rendered by accountants and described in the pamphlet *Approved Methods for the Preparation of Balance-sheet Statements.* This was the only authoritative description of a class of professional service which had ever been issued here, and, as the Institute was the author of that document, it seemed appropriate that when classification was under discussion by the Institute's committee the question of possible revision of the pamphlet should be considered before anything else. The committee knew that it would be a long and difficult undertaking to rewrite the instructions, so as to give expression to every salient point, but the work was to be done—and it was done at the cost of many days and perhaps a little weariness. One may weary even in well doing. However, the work of revision is now over and the committee is turning its attention to completion of its recommendations on the general classification of services, which will probably be available soon. When the special committee's report came before the executive committee it was unanimously approved, and at the meeting of council on April 8th the action of the executive committee was endorsed without dissent. The new instructions have now been presented to the federal reserve board and they are being printed by order of that board. Copies will probably be ready for distribution almost as soon as this issue of The Journal of Accountancy reaches the hands of its readers. And that is the history of the writing and publishing of the revised version of what has often been called "the accountant's bible."

What the Instructions Include

This new set of instructions contains almost everything that was in the pamphlet *Approved Methods for the Preparation of Balance-sheet Statements*, but the whole document has been rewritten, and it is in effect an old and valued friend fitted out in new habiliments suited to the times and the seasons.

For example, when the original text was written there was not much to be said about liability on account of federal taxes. The matter was scarcely mentioned. Yet within the narrow space of twelve years federal taxes have become at once the friend and the foe of every accountant. The new instructions deal with that question. Half a dozen similar items which have thrust themselves into prominent positions on the balance-sheet of today were not obtrusive in 1917, and they too received scant attention in the first text but receive comprehensive treatment in the new. It is, however, superfluous to attempt here a critical analysis of the changes. Everyone who reads this magazine will certainly wish to subject the entire report to careful consideration. It is not with the details but rather with the course of events that we are now concerned. It should be remembered, however, that the instructions do not present explicit rules to meet every contingency which may occur in the practice of every accountant. The purpose of the committee was to set forth what it believes to be the correct procedure in the ordinary verification of financial statements. The principal points are explained. Minor problems which will arise in specific and unusual cases are left to the discretion of the accountant. The instructions, therefore, are not to be regarded as complete, but, as we have said before, they do provide an indication of those things which the accountant must not leave undone if he is to certify that a statement of accounts in his opinion correctly portrays the financial condition of a business.

Arkansas Recognizes the Profession

One of the noteworthy enactments during the present excessively active season in state legislation is a new statute in Arkansas, laying a tax upon the incomes of persons and corporations. The prime purpose of the act is only mildly interesting. It merely brings another state into the rather unpopular list of jurisdictions in which one's income is liable to reduction for what is said to be the public good. But the Arkansas law has one section which is of great importance to the accountants of that state, and it is quite certain that members of the profession elsewhere will cast envious eyes toward their blessed brethren of the Ozarks. Article 5, section 25, paragraph 3, reads thus:

"Whenever a return is filed and a certified public accountant duly authorized under the law of Arkansas certifies that he has made an audit of the taxpayer's records for the income year and has prepared the return to which his certificate is attached, such return shall be accepted by the commissioner as prima facie true and correct."

This is not to be regarded as a loose and bland reliance upon anyone who calls himself an accountant, for we read in article 6, section 30, paragraph 7, the following warning:

> "Any certified public accountant who shall make a false certificate to any return as filed and offered to the commissioner pursuant to paragraph 3 of section 25 herein shall be guilty of a felony and shall, upon conviction thereof, be fined in any sum not to exceed $1,000 or be imprisoned not to exceed one year and his certificate shall be forthwith canceled and revoked."

But who can object to that? It seems only right that the recognition of the profession's abilities should be accompanied by recognition of the profession's responsibilities. And the man who deliberately makes a false return of income whether for himself or as agent for another does not deserve any sympathy when the burden of punishment is laid upon him. The new law in Arkansas is verily a step forward, and the accountants there are naturally much gratified. A prominent practitioner of that state writes that "if other states would have a similar provision and if the federal government would also incorporate in the federal law a similar provision, a great deal of the unnecessary examination being made by incompetent examiners in the employ of the government could be eliminated and the actual cost of enforcement materially reduced."

An Example to Other Jurisdictions

Of course there are many examiners who are not incompetent and it would not be well to dispense entirely with the field force of the bureau of internal revenue. There will always be need for a peripatetic inquisition of some sort. But it is indubitable that a vast saving of time, expense and discontent could be effected by the adoption of some such law or regulation as that which now appears on the statute books of Arkansas. Probably a law is not required. The recognition could be extended by the commissioner of internal revenue if he saw fit to do so. In some foreign countries where incomes are taxed—and where are they not?—a return bearing the signature or giving the name of a professional accountant who has prepared the statement is accepted at its face value in the absence of any cause to doubt its accuracy. There is nothing in our national tax law and we have no knowledge of anything in state laws which would prevent the acceptance of an accountant's report as prima-facie evidence of veracity. Very few people intentionally defraud the government. Most of the faulty returns owe their weakness to the ignorance of the taxpayer or of someone who because of an error of judgment considers himself competent to advise. It is not a great presumption to believe that the ordinarily intelligent accountant is able to prepare a tax return in a reasonably acceptable way, and, as the taxpayer is generally honest, it is not probable that he would attempt to induce his accountant to be dishonest for him. So it seems clear that even were the accountant evilly disposed there would be no inducement to falsity except in the case of a criminal client. Such clients are rare and accountants who would be seduced by them are rarer still. Where, then, can one find sound cause for opposition to the progressive plan of Arkansas? Surely a measure which facilitates reporting, avoids superfluous investigation, reduces the expense of collection and makes for the equanimity of the taxpayer is worth much, even though it may bring some benefit to the accountant. The only logical objection would arise in the ranks of the government employees who would be deprived of occupation.